RM NO. 10568

ATTACHMENT TO

REPLY OF THE AMERICAN PUBLIC COMMUNICATIONS COUNCIL

(NOVEMBER 14, 2002):

DECLARATION OF DON J. WOOD

Declaration of Don J. Wood

Introduction and Qualifications

1. My name is Don J. Wood. I am a principal in the firm of Wood &Wood, an economic and financial consulting firm. My business address is 4625 Alexander Drive, Suite 125, Alpharetta, Georgia 30022. I provide economic and regulatory analysis of the telecommunications, cable, and related convergence industries with an emphasis on economic policy, competitive market development, and cost-of-service issues.

2. I have testified on telecommunications issues before the regulatory commissions of thirty-two states, Puerto Rico, and the District of Columbia. I have also presented testimony regarding cost of service issues in state, federal, and overseas courts and have prepared comments and testimony filed with the Commission. My education, employment, and testimony history were attached as an exhibit to the August 29, 2002 filing of the American Public Communications Council ("APCC").

3. At the request of the APCC, I prepared the Dial-Around Cost Study submitted with APCC's request for a rulemaking. This study applies the Commission's bottom-up cost methodology as set forth in the *Third Report and Order*, and updates the 1999 application of that methodology with current input values to derive an updated value that will permit "fair" compensation to payphone owners for dial-around calls.

4. The purpose of this Declaration is to respond to the October 30, 2002 Comments of AT&T Corp., Office of the Attorney General of the State of Texas, Worldcom, Inc., Sprint Corporation, Global Crossing North America, Inc., Telstar International, Inc., IDT Corporation,

and the joint Comments of ATX Communications, Inc., Business Telecom, Inc., and US LEC Corp.

Comments of AT&T Corp.

5. AT&T argues (p. 9) that in several respects, the APCC Dial-Around Cost Study "abandons" the Commission's methodology for calculating the level of fair compensation for a dial-around call. In reality, the methodology itself remains unchanged and has been faithfully reproduced in this analysis. What has changed is the method used to collect an appropriate set of input values to be used with this methodology. In its analysis described in the *Third Report and Order*, the Commission had limited information at its disposal and ultimately had to rely on estimates and broad averages submitted by industry participants (and to sometimes the utilize an average of conflicting estimates).[1] In spite of its limitations, this information represented the best information available at that time. In order to develop a reliable set of inputs that reflects 2002 values, a more extensive data collection effort was undertaken. This effort yielded information that is more reliable than that available in 1999 for two primary reasons: (1) while average values are ultimately utilized to populate the Commission's methodology, the development of these averages is described in detail, and (2) the information represents the characteristics of a demonstrably broad base of payphone locations.

6. Pursuant to AT&T's theory, the development of a dial-around compensation rate in 2002 must either be based on the same inputs relied upon in 1999, or must be based on a similar set of broad averages with no demonstrated basis. Surely the Commission did not intend for the data limitations present in 1999 to become institutionalized into the methodology itself, so that any

[1] For example, see paragraphs 169, 174, 176-177, 179, 186.

new information must be discarded, or that new, more reliable, or more detailed sources of information must be ignored.

7. AT&T argues that demand elasticities must be considered when developing a "fair" rate of compensation for dial-around calls. AT&T argues (pp. 6-8) that consumer demand for "dial-around" calls is highly elastic, and that any change in the dial-around compensation rate will inevitably "significantly diminish consumer demand for payphone services." AT&T offers no empirical data to support this assumption of high elasticity of demand for dial-around services. In 1999, information available to the Commission suggested that demand for dial-around services is inelastic.[2] AT&T's argument also implicitly assumes that the asserted demand elasticity is relatively constant across a broad base of payphone locations. This assumption is likewise unsupported and directly contradicts the Commission's previous conclusion that the elasticity of demand for particular payphone services is likely to vary among locations.[3] AT&T further implicitly assumes that elasticity will remain roughly constant across a range of prices; this assumption likewise has no empirical support. Finally, AT&T's argument relies on an important (but unstated and unsupported) argument that the marketplace can and will provide a readily-available substitute for an end user that opts not to make a dial-around call at a payphone. In order for the Commission to now incorporate elasticity into its pricing model, as AT&T requests, would require the abandonment of the bottom-up methodology adopted in the *Third Report and Order* and the collection of reliable data regarding the elasticity of dial-around services (information that AT&T either does not have or has chosen not to produce).

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2 *Third Report and Order*, paragraphs 101-111. The Commission ultimately concluded that this information was not sufficiently reliable to form the basis of a pricing decision for dial-around compensation.

3 *Id*., paragraph 36.

8. AT&T next argues (p. 21) that the Commission's previous "top-down approach" must be used to assess the reasonableness of the results of any bottom-up analysis. AT&T specifically argues that the Commission used the top-down approach in order to "validate" the result of the bottom-up approach. As an initial matter, a careful reading of the *Third Report and Order* indicates that "validate" is much too strong a word. At most, the Commission's use of the top-down methodology should be described as a check of "reasonableness."

9. More importantly, upon a closer review it appears that any previous correlation between the results of the Commission's top down and bottom up methodologies may have been largely coincidental. As AT&T points out, the top down methodology begins with an assumed market price for a coin call and subtracts a calculated per-call cost for the coin mechanism, local call termination, and coin collection. The stated objective of this process is to create a scenario in which "all types of calls could be viewed as making the same contribution to covering joint and common costs."[4] A practical problem is created by the fact that the cost of the coin mechanism is, like most costs associated with a payphone location, volume insensitive. In order to apply the top down analysis, the Commission converted these costs to a per-call basis by dividing monthly costs by an assumed number of monthly coin calls.

10. Over time, as the volume of coin calls changes the calculated per-call cost changes. As AT&T's analysis illustrates,[5] the calculated per-call cost of the coin mechanism has now more

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4 *Third Report and Order*, paragraph 8.

5 In additional to being conceptually irrelevant in this context, AT&T's analysis suffers from a number of questionable factual assumptions. First, over the past three years ILECs in several states have reduced the local usage charges applicable to payphone access lines. The current average is likely to be less than the $.038 assumed in the *Third Report and Order*. Second, AT&T assumes a lower volume of coin calls but holds coin collection costs per month constant at $11.59 per month. This assumption is inconsistent with how these costs are incurred: coin collection is required when the payphone unit signals that it is full. Fewer coin calls is

than doubled, from $.054 to $.109. As the volume of coin calls decreases, the calculated per-call cost of these calls increases, yielding a decrease in the "contribution to covering joint and common costs." In order to maintain a constant contribution, the top down methodology reduces the dial-around compensation rate to reflect this lower contribution for coin calls. This reduction is independent of the level of non-coin costs at a given payphone location (or the non-coin cost for payphone locations on average), and independent of the number of non-coin calls. In direct contrast, the bottom up methodology excludes coin mechanism, coin collection, and local termination costs completely, and directly addresses the recovery of the non-coin location costs over the total (coin and non-coin) number of calls. As a result, the bottom up methodology has the distinct advantage of separating the recovery of coin-related costs from the recovery of other location costs. This separation permits a "fair" rate for dial-around calls to be calculated based on the recovery of fixed (non-coin) location costs.

11. Any results generated by the application of the top down methodology offer little insight at this time. As the Commission has concluded, "if our goal is to price dial-around calls such they make a proportionate contribution to joint and common costs, we cannot do so by basing their price on the local coin calling price, because we do not know how individual PSPs price local coin calls in relation to the recovery of joint and common costs. Therefore, upon reconsideration, we find unreliable the assumption that PSPs set prices so that each call recovers

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likely to result in fewer coins and a corresponding reduction in the average monthly coin collection costs. Third, AT&T updates the assumed local coin rate to $.50, but ignores other types of coin calls that should share in the recovery of coin-related costs. For example, 1+ coin calls are likely to generate more than $.50 in revenue. If this is the case, AT&T started at the wrong point; the average coin revenue per call is higher than $.50. Each of these flawed assumptions serves to understate the costs to be recovered through a coinless call, and thereby understates the rate for dial-around compensation.

an equal amount of joint and common cost."[6] This observation is correct. The recovery of coin-related costs is, and should be, a separate and distinct consideration from the recovery of fixed location costs that are not coin related. The top down methodology assumes a given and fixed ratio of coin to non-coin calls, and assumes that a rational pricing strategy for payphone providers would be to attempt to equalize the margin among all call types at all locations. These assumptions may or may not be valid in a short-run analysis, and are unlikely to be true in a long-run analysis. In the end, any convergence – or divergence – of the results of the top down and bottom up methodologies depends on multiple factors. While the Commission may have found some comfort in the observation that similar results have been generated by these two fundamentally different methodologies in the past, there is no reason to expect such similarities to exist now or in the future. AT&T's assertion that the results of the Dial-Around Cost Study should be called into question because they cannot be reconciled with AT&T's application of the top down methodology (using the RBOC Coalition's call volumes) has no basis in basic economic concepts, and is not supported by the Commission's conclusions in the *Third Report and Order*.

12. AT&T further argues that the equipment investment values included in the Dial-Around Cost Study are inappropriate because they fail to reflect accumulated depreciation of the embedded base of assets (p. 21). This argument has no merit for at least three reasons. First, rational economic decisions are based on the replacement cost, not booked cost, of assets. If payphone providers are permitted to recover only booked investment minus accumulated depreciation, they will be unable to invest in replacement assets when the existing assets reach the end of their useful life. Second, the Commission defined the cost basis for the bottom up

6 *Third Report and Order*, paragraph 70.

methodology to be forward-looking. In the *Third Report and Order*, the Commission listed specific differences between the cost methodology used in this context and the Commission's TELRIC methodology adopted for other purposes.[7] This list of differences does *not* include a different treatment of the return on, or return of, investments. The TELRIC methodology is (properly) based on replacement costs. Third, the Commission has previously rejected an equivalent proposal made by Sprint. AT&T argues (p. 21) that the dial-around compensation rate should reflect the fact that "these phones, by now, have been almost fully depreciated." In the *Third Report and Order*, the Commission correctly concluded that the use of such a "non-economic accounting methodology alone justifies setting prices on a going-forward basis. More importantly, because the marketplace sets prices on a forward-looking basis, we do not use embedded costs in this Order."[8] AT&T has offered no basis for either a re-invention of basic economic concepts or for a reconsideration of the Commission's conclusion.

13. Finally, AT&T, through the Declaration of Robert M. Bell, describes several purported flaws in the development of the Dial-Around Cost Study. Mr. Bell's stated concerns are as follows: (1) the APCC study "may" include payphones "that are subsidized by a premises owner" (paragraph 11), (2) a potential for bias is created by the response rate to the survey (paragraph 13), (3) bias may be created by the respondent's knowledge of the purpose of the survey. In each of the above stated concerns, Dr. Bell describes a *potential* for bias; he does not argue that the results of the Dial-Around Cost Study are in fact biased. For each of his stated concerns, I will explain why this potential for bias has in fact not translated into actual bias in the study results.

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7 Paragraph 73, including footnote 131.

8 Paragraph 131.

14. *The APCC study "may" include payphones "that are subsidized by a premises owner."* This assertion is simply factually incorrect. Survey responses related to payphone locations in which the payphone provide pays a commission to the premises owner, *and* payphone locations in which the premises owner pays a commission to the payphone provider, were excluded from the analysis of marginal locations.[9]

15. *A potential for bias is created by the response rate to the survey.* Dr. Bell is correct that information regarding 408 of the 940 payphone locations originally identified was ultimately collected. This response exceeds the rate that is typical of many often-used data collection vehicles, and the potential for such a response rate was fully considered in the development of a larger than necessary sample of payphone locations. Dr. Bell correctly points out that the existence of non-response error is dependent on two conditions: (1) a significant number of people in the survey sample do not respond, *and* (2) those not responding have a different – and relevant – set of characteristics from those who do respond. The basis for Dr. Bell's concern appears to be an assumption that potential respondents had insight into the impact that their information would have on the final result, and could therefore "self-select"[10] their information based on this insight into the process and their unique characteristics. As described in the following paragraph, there is no basis for such an assumption and therefore no reason to assume that the non-respondents share a set of "low cost" or "high volume" characteristics.

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[9] The only exceptions to the pure "zero commissions" rule are those locations in which the amount paid by either party to the other is a token or trivial amount that is insufficient in magnitude to materially impact the economic viability of the location.

[10] In other words, these potential respondents could strategically decide whether to become respondents or non-respondents based on their expectations regarding how their information might impact the study results.

16. *Bias may be created by the respondent's knowledge of the purpose of the survey.* Dr. Bell is correct that a limited amount of information regarding the purpose of the data collection effort was included in the instructions to the survey. This information was provided in an attempt to encourage *all* recipients to respond with the requested information. The first fallacy in Dr. Bell's argument is his assumption that all potential survey respondents were aware that they "stood to benefit if the APCC study showed a low volume of calls and high [per-location] costs." There is absolutely no information that suggests such a level of insight among potential respondents. The written instructions to all potential respondents stressed the need for accurate and unbiased information. Other than a cover letter describing the importance of the information, all contact between potential respondents and APCC was strictly limited. Similarly, all contact with potential respondents was strictly limited to one individual at Wood & Wood in order to carefully control the information provided to respondents. The email and telephonic requests for clarification made to Wood & Wood by potential respondents suggested absolutely no insight whatsoever into even the basic question of whether a higher or lower reported call count would impact the results in a "beneficial" way. Dr. Bell assumes an awareness and understanding of the Commission's methodology that, by all appearances, simply does not exist.[11]

17. The second fallacy in Dr. Bell's argument is his implicit assumption that all potential respondents had an insight into the characteristics of other payphone providers. In order for a

[11] The only possible exceptions to this observation are the large payphone providers who were contacted. As a rule, these providers did not seek clarification of the survey instructions and, as a result, I do not have direct experience with their level of insight. In order to allay Dr. Bell's concerns, it is notable that these large providers responded to the survey (i.e. they did not "self-select" themselves as non-respondents based on their understanding of the characteristics of their locations and the Commission's methodology), yet the inclusion of the locations resulted in a decrease in the reported per-call cost results.

potential respondent to make a strategic decision to "self select" itself as a non-respondent, it would need to have some insight into both its own characteristics and how those characteristics compare to an average or baseline value for other providers. Again, there is absolutely no evidence that any potential respondents had such insight. To the contrary, all provider-specific information has been closely held and treated as trade secret information by Wood & Wood (acting as an independent third party repository of this information). Provider-specific information collected through this survey is not available to the APCC or to any individual member, and neither the APCC nor any individual provider had access to the industry average or baseline values until after data collection was completed and the results of the study published. In short, no provider had knowledge of how its characteristics compared to the average, and therefore had no basis upon which to strategically withhold its information in hopes of influencing the study result in a "beneficial" direction.

Comments of the Office of the Attorney General of the State of Texas

18. The Texas Attorney General argues (p. 2) that the data underlying the Dial Around Cost Study do not represent "a true random sampling of payphones in the marketplace." While it is correct that the population of payphone locations sampled does not consist of *all* payphones, it does consist of over 400,000 payphone locations distributed throughout the country. The sample was constructed in order to ensure proportional representation of different geographic areas, in recognition of the fact that several important cost drivers are likely to vary among geographic regions of the country. Within this population, sampling was indeed random.[12] The marginal locations utilized in the study were not, as the Texas Attorney General asserts, "self-selected as responses to a survey." Surveys were sent to the providers of a randomly selected set of

[12] This process is described in section D.4.1 of the Dial-Around Cost Study documentation.

payphone locations, and all survey responses were utilized (i.e. none were "selected" or discarded).

19. The Texas Attorney General goes on to make the unsupported (and unsupportable) assertion that "survey responses are well-known to be biased and obviously are not based on an objective source of information." To the contrary, the data collection process was carefully controlled in order to ensure such objectivity. Finally, The Texas Attorney General's argument that potential respondents "have an incentive not to respond if they believe that doing so could ultimately harm their economic interests" presupposes a high level of insight into both the Commission's methodology and the average characteristics of other providers. As described above in response to a similar assertion by AT&T, there is absolutely no evidence that potential respondents had such insight,[13] and no evidence that such "self-selection" has taken place.

20. The arguments of other commenters largely mirror those of AT&T. In the remainder of this Declaration, I will describe the primary distinctions and respond to any new arguments raised. In general, however, my response to AT&T applies to the equivalent arguments made by other commenters.

Comments of Worldcom, Inc.

21. Worldcom makes two points regarding the recovery in investments that appear to be mutually exclusive. First, it argues (p. 16) that a proper calculation of a "fair" level of dial-around compensation should not "strive to reproduce the historic levels of asset costs, staffing levels, and inventory levels." The Dial-Around Cost Study does not attempt to do so. All

[13] In reality, all contact between potential respondents and Wood & Wood strongly suggests that the opposite is true.

categories of included costs, including both capital and non-capital items, are independent of historic levels. Capital costs are properly based on the cost to efficiently replace existing capacity. This approach is consistent with the Commission's description in the *Third Report and Order* of the forward looking methodology to be employed.

22. Worldcom then goes on to argue (p. 17) that the costs associated with the recovery of investments should be based on partially or fully depreciated assets rather than the full cost of replacement. In addition to being at odds with Worldcom's first argument, such an approach is inconsistent with the manner in which rational decision-making regarding pricing should be done; a firm that prices based on booked value less accumulated depreciation will be unable to replace assets at the end of their useful life. As described previously in response to AT&T, this approach is also inconsistent with both TELRIC and the forward-looking methodology adopted in the *Third Report and Order*.

Comments of Sprint

23. Sprint primarily argues against the continued use of the "Commission's current market-distorting methodology" and in favor of a regulatory paradigm that will encourage the removal of payphones from service (p. 4). The argument is premised on an assumption that the demand for dial-around calls is highly elastic. Like AT&T, Sprint offers no data in support of this assumption, and offers no basis for the abandonment of the Commission's previous conclusion that the demand for these services is likely to be inelastic and to vary by location.

Comments of Global Crossing

24. Global Crossing's argument relies completely on the underlying premise that the demand for dial-around services is highly elastic. Unlike AT&T and Sprint, who argue for elasticity but

(prudently) make no attempt at quantification, Global Crossing takes the extra step of arguing that the elasticity is actually a value greater than –1; that is, an increase in price will create a corresponding decrease in demand that is sufficient in magnitude to cause total revenue to decrease. With no empirical support whatsoever, Global Crossing boldly states (p. 2) that the Commission's creation of the dial-around rate of $.24 in 1999 is directly responsible for the experienced reduction in call volumes, revenue, and payphone deployment. Based solely on an observation that dial-around call volumes have decreased, Global Crossing concludes (p. 5) that the available data suggest that the dial-around compensation rate of $.24 is too high rather than too low.

25. Global Crossing's conclusion relies on several important, but unstated, assumptions. First, it is necessary to assume that no factors have influenced the volume of dial-around calls *except* the level of the dial-around compensation rate. Second, it is necessary to assume that contrary to the information available to the Commission in 1999, and that the demand for dial-around services is highly elastic. Third, it is necessary to assume that this elasticity exists across a wide range of prices.[14] Fourth, it is necessary to assume that demand elasticity is constant among different payphone locations (again in contrast to the Commission's conclusions in 1999). Fifth, it is necessary to assume that substitute services have been readily available in all locations and to each end user that Global Crossing now argues elected not to make a dial-around call because of price. Other than the undisputed observation that the volume of dial-around calls has decreased over the past three years, Global Crossing offers no support for any of these counter-intuitive conclusions.

[14] Measures of elasticity apply to a single point on a products demand curve; they do not apply across multiple points unless the demand curve is linear. As a result, demand may be elastic at prices above a certain level, but inelastic for prices below that level.

Comments of Telstar

26. Telstar relies on the assumption of price elasticity described above and in response to AT&T. Like AT&T, Sprint, and Global Crossing, Telstar offers no empirical evidence to support its claims.

Comments of IDT

27. IDT relies on the Commission's top down methodology to support a claim that payphone providers should be willing to accept a level of compensation for dial-around calls if that compensation provides a contribution to fixed costs equal to that implied by a $.25 coin call. As described previously in response to AT&T, the application of the top down methodology provides no useful information in this context. As a practical matter, the IDT proposal would effectively eliminate dial-around compensation. Using AT&T's calculation (set forth at p. 22 of its Comments) of the per-call cost of the coin mechanism, local termination charges, and coin collection costs, the implied dial-around rate according to IDT is .25 - .109 - .038 - .074 = .029, or 2.9 cents per call. According to IDT's application of the top down methodology, a reduction of about 10% in the current level of coin calls would take the dial-around rate to zero.

Comments of ATX Communications, Business Telecom, and US LEC

28. ATX et. al. (p. i) describe the results of the Dial-Around Cost Study as "unsupported." This is simply not the case. These results are supported by an independent and objective analysis of costs. In contrast, the values relied upon by the Commission in the *Third Report and Order* were largely without such supporting analysis and documentation. The information currently available to the Commission represents a significant step forward in both accuracy and reliability. ATX et. al. now seek to raise the evidentiary bar to ridiculous heights, as evidenced

by their insistence (p. 8) that *all* payphones must first be studied (presumably individually) before any conclusions can be drawn. There is no evidence that the data relied upon by the Commission in the *Third Report and Order* was the result of a study of *all* payphone locations, and such an approach would not be desirable.[15] In addition to the creation of excessive administrative cost and delay, an attempt to study all locations would ultimately produce results that are less reliable than a result that relies on a statistically valid sample.

29. If ATX et. al are simply suggesting that all payphone providers be studied, then their point is largely moot. Information regarding payphones provided by BOCs, PSPS associated with BOCS, and PSPs has been produced in the context of this proceeding. The information now available is equal in breadth to the information available in 1999, and has considerably more depth.

30. Finally, ATX et. al. (p. 2) argues that an increase in the dial-around compensation rate will harm the payphone industry, relying (like AT&T, Sprint, Global Crossing, and Telstar) on a set of unstated and wholly unsupported assumptions regarding the price elasticity of dial-around services. Like the other commenters, ATX et. al. offer no empirical data in support of these assumptions.

[15] As pointed out in paragraph 147 (cited by ATX), the average call counts ultimately relied upon were not based on a study of call counts at all, but were estimated based on assumptions regarding average revenue.

I declare under penalty of perjury that the foregoing is true and correct to the best of my belief.

/S/_____
Don J. Wood